TAX POLICY

READINGS AND MATERIALS

THIRD EDITION

PHILIP D. OLIVER

FOUNDATION PRESS

CHAPTER ELEVEN

TAX EXPENDITURES

The federal income tax system consists really of two parts: one part comprises the structural provisions necessary to implement the income tax on individual and corporate net income; the second part comprises a system of tax expenditures under which Governmental financial assistance programs are carried out through special tax provisions rather than through direct Government expenditures. This second system is grafted on to the structure of the income tax proper; it has no basic relation to that structure and is not necessary to its operation. Instead, the system of tax expenditures provides a vast subsidy apparatus that uses the mechanics of the income tax as the method of paying the subsidies. The special provisions under which this subsidy apparatus functions take a variety of forms, covering exclusions from income, exemptions, deductions, credits against tax, preferential rates of tax, and deferrals of tax.[a]

A. INTRODUCTION

Tax expenditures are tax benefits used as incentives or rewards in lieu of outright payments by the government.. As the opening quotation from Professor Stanley Surrey indicates, tax expenditures include credits; exclusions and exemptions; deductions not justified in computing net profit; lower tax rates on specified types of income; and, increasingly, timing benefits such as accelerated deductions and deferrals in accounting for income.

What we now regard as "tax expenditures" have perhaps always been with us. Tax expenditures have grown enormously in recent decades, however. Their growth reflects not only the increased size and complexity of the income tax, but also the increased willingness of Congress to influence economic and social choices by individuals and businesses.

Present terminology ("tax expenditure") and our awareness of the phenomenon are both of relatively recent vintage, and Professor Surrey is largely responsible for both. He served as the first Assistant Secretary of Treasury for Tax Policy under Presidents Kennedy and Johnson, and his work in that capacity led to the compilation of a Tax Expenditure Budget for the Fiscal Year 1968 published in the Treasury Secretary's annual report.

Six years later the Budget Act of 1974 complemented requirement [illegible] that the Congressional Budget Committee and the President

present annual estimates of the revenue costs of existing tax expenditures. These annual cost estimates help one appreciate the magnitude of the various tax expenditures.

Surrey's key contention was that direct expenditures and tax expenditures were substantively interchangeable. At the same time, the political approval process and the budgetary oversight of the two forms of expenditure were (and remain) completely different. Not being outlays from the Treasury, tax expenditures are not reflected in government expenditures and are not subject to the annual congressional appropriation process. They are not items listed in the budget and affect the budget only through tax receipts being lower than they otherwise would be.

Tax expenditures have obvious political appeal for members of Congress. In the case of new tax expenditures, or of liberalizing existing tax expenditures, some discipline has been introduced by a requirement Congress has imposed on itself that bills reducing revenues must contain offsetting revenue increases over a five- or ten-year span. As discussed in Chapter Seventeen, this budget process is subject to manipulation. Moreover, the process does not affect existing, ongoing tax expenditures. "Sunset" rules, which would terminate existing tax expenditures unless they were explicitly continued, have been proposed but not adopted.

Perhaps the clearest examples of tax expenditures are the incentive tax credits, which are usually calculated as a specified percentage of the taxpayer's expenditure on the rewarded behavior. The investment tax credit ("ITC") was the major tax credit between its initial enactment in 1962 and its sharp curtailment in 1986. Before 1986, the ITC allowed taxpayers making investments in tangible personal property (and some real property) for business use to offset their income tax liability by ten percent[b] of the cost of their qualifying investments. Investment tax credits were presented as explicit incentives to invest. As initially proposed by President Kennedy, the credit would have been available only for incremental investments over the taxpayer's normal replacements of business assets, but the incremental investment approach had been abandoned by the time the credit was enacted.

The ITC was the precursor of a flood of other tax credits. These included a credit for increasing outlays for research and development, a credit for providing low-income housing, a credit for wages paid to workers considered to be disadvantaged in various specified respects, education credits, a child care credit, an earned income tax credit ("EITC") for low-income taxpayers, a child tax credit, and a credit for elderly and disabled taxpayers. Unlike tax credits designed to be incentives, the last two tax credits—and arguably the

b When first enacted in 1962, the ITC was only seven percent.

EITC as well—are designed merely to provide relief from tax.

Traditionally, the EITC has been unique in providing actual cash supplements, as opposed to a reduction in taxes owed. With the exception of the EITC, therefore, credits have benefitted only persons who otherwise would owe income tax, and thus have provided no incentive to individuals whose incomes are so low that they have no tax liability or to corporations that are operating at a loss. One response to this perceived problem has been to suggest making the credits "refundable"—*i.e.*, an amount equivalent to the tax credit would be given to persons who qualify for the credit whether or not they have tax liability against which to apply it. Thus, a "refund" would be made of a tax that had not been paid. While the EITC remains, by far, the most important refundable tax credit, there has been some recent expansion of the concept. For example, the credit of section 35 for certain health insurance costs is refundable, and section 24(d) makes the child tax credit partly refundable. (For these purposes, the wage withholding tax credit is not regarded as refundable, because the refund is out of tax previously withheld from the taxpayer's compensation.)

Tax exemptions and deductions from adjusted gross income also can be tax expenditures. As with nonrefundable credits, exemptions and deductions are useful only if the eligible person otherwise would owe tax. Tax deductions and exemptions of specified types of income can also be of benefit by increasing net operating losses that are carried over to offset taxable income in other years.

Unlike tax credits, exemptions and deductions vary in value among taxpayers—the higher the tax bracket, the greater the tax expenditure. For example, a $1,000 percentage depletion deduction is worth $350 to a corporation facing a 35 percent marginal tax rate, but only $150 to a corporation facing a 15 percent marginal tax rate. If the taxpayer has exhausted the tax basis of the mineral property giving rise to the percentage depletion deduction, the tax expenditure, whether $350 or $150, is an outright benefit—not merely a postponement of tax—because there is no compensating downward basis adjustment.

It is more difficult to calculate the benefit from tax expenditures that arise from accelerating deductions to which a taxpayer eventually would be entitled under "normal" rules. The value of speeding up such a deduction depends on two factors: how long it would have been before the taxpayer would have received the deduction in the absence of the tax expenditure provision, and the time value of the tax deferred by speeding up the deduction. The time value to the taxpayer may be different from the cost to the Government of postponing its receipt of tax, raising the question of what interest rate should be used to calculate the amount of the tax expenditure.

Although the basic idea of tax expenditures seems reasonable, putting the concept into use has proved difficult and controversial. Furthermore, even the basic concept has been challenged. As respects exemptions and deductions, the debate over tax expenditures merges into the debate over broadening the tax base.

Notes and Questions

(In)efficiency of tax expenditures

1. A significant question in using and structuring tax expenditures is whether they are efficient—does the Government get a sufficient bang for its buck? In many instances, such efficiency is difficult or impossible to measure, because of the nature of the benefit sought. (For example, measuring the benefit conferred on society, and on the individual workers, by an employer hiring disadvantaged workers would necessarily entail some level of subjectivity.) Nonetheless, Professor Calvin Johnson argues forcefully that, at least at present, tax incentives are extremely inefficient.

In large part, Professor Johnson bases his argument on the yields of tax-exempt bonds, because there, we can measure rather accurately the efficiency of the subsidy. Section 103 excludes from federal tax the interest on many state and local bonds. If a taxable bond yields 10 percent and an equivalent (considering such things as risk and liquidity) state bond yields 8 percent, this suggests that the investor is paying an "implicit tax" of 20 percent—the investor is voluntarily forfeiting 20 percent of yield in order to avoid taxation. This is a measure of efficiency because "[t]he implicit tax represents the only public return from the exemption system, in the form of cheaper costs for states and localities. The rest of the cost of the exemption is lost in terms of the purpose of the exemption, a cost without any delivered benefit."[c] Purchasing the state bond under the interest rates described would make sense only for a taxpayer whose marginal tax rate exceeded 20 percent. The governmental benefit (aiding the state) and the cost (foregone revenue) can both be measured accurately. If a taxpayer in the 35 percent bracket purchased a tax-exempt $1,000 bond under the interest rates assumed above, the federal Government would lose $35 in foregone revenue ($100 taxable interest x 35 percent) while the state would benefit to the extent of $20 in saved interest. (Note that the exclusion would be ideally efficient if the market drove the rate of the tax-exempt bond to 6.5 percent—this would mean that taxpayers in the top bracket (35 percent) would be indifferent between the taxable and tax-exempt investment, and that all foregone federal revenue

c. Calvin H. Johnson, *A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax*, 56 SMU L. REV. 13, 14 (2003).

would have been diverted to the intended beneficiary, the state, in the form of lower interest expense.[d]

Professor Johnson reports that the implicit tax on tax-exempt bonds "has been dropping in recent years, and is modest under current conditions, lower at times than the lowest statutory tax bracket of 10%."[e] Professor Johnson argues that the significance of this finding goes well beyond tax-exempt bonds. The low implicit rate on tax-exempt bonds indicates that investors find it easy to avoid taxes, and therefore are not willing to forego much income in order to achieve tax exemption. For this reason, Professor Johnson concludes that the use of tax incentives should be sharply curtailed and our generally porous tax system repaired:

> More generally, the modesty of the implicit tax means that there is a need for general repairs of the federal tax base. The demand for tax avoidance that would settle the implicit tax at the top statutory rate is swamped, not just by § 103 bonds, but by other investments that Congress has attempted to subsidize by giving or preserving a tax advantage. Congress, for instance, gives or expands the tax benefits of qualified pension funds or houses, and thousands of other things, by giving tax deductions that do not reflect economic cost or by giving exclusions for economic benefits.
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> With implicit tax so low, however, the use of the tax system for incentive or subsidy is no longer responsible. The loss to the system in cost is far higher than the benefit delivered. * * *
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> The low implicit taxes indicate that the existing rates are fictive, or at least voluntary, for well-advised taxpayers. If they faced more than a paper tiger from the tax system, generally they would pay higher implicit tax. Reducing the rates and repairing the tax base would reduce the harm inflicted by the tax system.[f]

2. Much earlier, reports Dr. Gerard Brannon, the granddaddy of incentive tax provisions, the investment tax credit, had been condemned as inefficient: "That credit [ITC] operates like a uniform reduction in the price of equipment but in truth the price of equipment hasn't been reduced. Leading investors to think that equipment is cheaper than it is will distort investment. * * * When capital seems very cheap one tends to waste it."[g]

3. Do the preceding notes lead you to think that the best form for incentive tax expenditures to take is that they not be employed at all?

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d. *Id.* at 13.

e. *Id.* at [illegible]

f. Gerard M. Brannon, [illegible] 39 Nat'l Tax J. [illegible] (1986) [illegible] (emphasis in original).

Consider this question throughout the chapter, keeping in mind that no government program—whether tax expenditure or direct expenditure—works with perfect efficiency.

4. *Political attraction of tax expenditures.* When one considers the political dynamics involved, there is every reason to believe that Congress will continue to make extensive use of tax expenditures. Assume that, for whatever combination of political and policy reasons, members of Congress support the goal of delivering a given benefit to a given segment of society. Assume further that the benefit can be delivered, equally well, either in the form of a direct expenditure or a tax expenditure. Consider the political considerations in the choice. Voting for a direct expenditure requires a vote for more spending, a vote for bigger government. By delivering the equivalent benefit in the form of a tax expenditure, members of Congress can tell voters that they have voted to cut taxes, and have refrained from voting in favor of additional spending.

B. TAX EXPENDITURES DESCRIBED AND DEFENDED

As noted above, since 1974 Congress has required the annual compilation and quantification of tax expenditures. The first excerpt below is the Office of Management and Budget's Fiscal Year 2011 explanation of the tax expenditures concept in operation. In terms of tax policy, this document is of considerable interest in several ways. First, a perusal of the pages of tax expenditures gives a sense of the breadth and magnitude of tax expenditures, each of which could be evaluated in terms of its policy justification. But more broadly, the accompanying document makes clear the complexity and uncertainty of the entire concept of tax expenditures and the tax expenditure budget. The concept of tax expenditures requires a "baseline" from which the "special" provision departs, but the baseline is not always clear.

A related issue is whether it matters, in the real world, whether a given tax provision is classified as a part of the "normal" tax structure or as a "tax expenditure." In one sense, the classification is only an academic exercise—dollars saved from a lower tax burden spend just as well whether the lower tax burden results from a tax expenditure or not. On the other hand, classification as a tax expenditure raises the political exposure of a tax provision. If the provision is viewed as part of the "normal" system, it is less subject to attack than if it is viewed as an "expenditure," which should have to compete for limited federal dollars in a political environment in which it is never possible to spend as many dollars as Congress might wish.

The second excerpt is from an appendix of the final tax expenditure

budget prepared by the George W. Bush Administration. A similar appendix was utilized through most of the Bush years, but was promptly discarded by the Obama Administration. The traditional tax expenditure budget was calculated similarly by the Bush and Obama teams, but the Bush appendix attempted additional calculations. First, the Bush appendix calculated tax expenditures assuming either of two alternative "baselines"—a "comprehensive" (or Haig-Simons) income tax baseline, and a consumption tax baseline. Additionally, the Bush appendix examined an aspect of an issue ignored in traditional tax *expenditure* analysis—a focus on "negative tax expenditures," those instances in which deviations from the norm increase, rather than decrease, the burden on taxpayers.

In the third excerpt, Professor Edward Zelinsky, who has written extensively about tax expenditures, takes on the presumption that tax expenditures are in some sense illegitimate. Professor Surrey (and many others following his lead), while acknowledging that tax provisions *could* be as carefully crafted as direct expenditure measures, clearly thought that the direct expenditure process was generally to be preferred. Obvious arguments support a preference for the use of direct expenditures. After all, direct expenditures are enacted through a legislative process centering on substantive congressional committees rather than the less-expert House Ways and Means Committee and Senate Finance Committee, and are administered by agencies with subject matter expertise rather than the Internal Revenue Service. Professor Zelinsky argues that appearances can be deceiving, and that the tax expenditure process may offer significant advantages.

ANALYTICAL PERSPECTIVES BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 2011

Office of Management and Budget

Pages 207-13, 220-24 240-41 (2010)

Tax Expenditures

The Congressional Budget Act of 1974 (Public Law 93-344) requires that a list of "tax expenditures" be included in the budget. Tax expenditures are defined in the law as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability." These exceptions may be viewed as alternatives to other policy instruments, such as spending or regulatory programs.

Identification and measurement of tax expenditures depends importantly on the baseline tax system against which the actual tax system is compared. The tax expenditure estimates presented in this chapter are patterned on a

comprehensive income tax, which defines income as the sum of consumption and the change in net wealth in a given period of time.

An important assumption underlying each tax expenditure estimate reported below is that other parts of the Tax Code remain unchanged. The estimates would be different if tax expenditures were changed simultaneously because of potential interactions among provisions. For that reason, this chapter does not present a grand total for the estimated tax expenditures.

Tax expenditures relating to the individual and corporate income taxes are estimated for fiscal years 2009–2015 using two methods of accounting: current revenue effects and present value effects. The present value approach provides estimates of the revenue effects for tax expenditures that generally involve deferrals of tax payments into the future.

* * *

Tax Expenditures in the Income Tax

Tax Expenditure Estimates

All tax expenditure estimates presented here are based upon current tax law enacted as of December 31, 2009. Expired or repealed provisions are not listed if their revenue effects result only from taxpayer activity occurring before fiscal year 2009. * * *

The total revenue effects for tax expenditures for fiscal years 2009–2015 are displayed according to the Budget's functional categories in Table 16–1.[g] * * *

Two baseline concepts—the normal tax baseline and the reference tax law baseline—are used to identify and estimate tax expenditures. For the most part, the two concepts coincide. However, items treated as tax expenditures under the normal tax baseline, but not the reference tax law baseline, are indicated by the designation "normal tax method" in the tables. The revenue effects for these items are zero using the reference tax rules. The alternative baseline concepts are discussed in detail [below].

* * *

Table 16-3 ranks the major tax expenditures by the size of their 2011-2015 revenue effect. * * *

In the 2005 Analytical Perspectives, the treatment of capital gains was changed to exclude the portion of capital gains derived from corporate equity from the estimate of the tax expenditure for preferential tax rates on capital gains. In addition, the preferential rates on qualified dividend income that

g. For clarity of presentation, Table 16-1 as excerpted below provides data for the years 2011-15. (Ed.)

Table 16-1. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES

(in millions of dollars)

	Total from corporations and individuals					
	2011	2012	2013	2014	2015	2011-15
National Defense:						
Exclusion of benefits and allowances to armed forces personnel	11,530	11,570	11,920	12,370	12,860	60,250
International Affairs:						
Exclusion of income earned abroad by U.S. citizens	5,870	6,160	6,470	6,790	7,130	32,420
Exclusion of certain allowances for Federal employees abroad	1,020	1,070	1,120	1,180	1,240	5,630
Inventory property sales source rules exception	2,830	3,070	3,320	3,590	3,890	16,700
Deferral of income from controlled foreign corporations (normal tax method)	32,720	33,870	34,490	33,930	34,130	169,140
Deferred taxes for financial firms on certain income earned overseas	5,770	5,980	6,090	5,990	6,020	29,850
General Science, Space and Technology:						
Expensing of research and experimentation expenditures (normal tax method)	4,560	5,720	6,690	6,930	7,710	31,610
Credit for increasing research activities	3,850	3,080	2,460	1,964	1,568	12,922
Energy:						
Expensing of exploration and development costs, fuels	1,180	920	900	680	340	4,020
Excess of percentage over cost depletion, fuels	670	940	1,130	1,160	1,190	5,090
Alternative fuel production credit	20	10	0	0	0	30
Exception from passive loss limitation for working interests in oil and gas properties	20	20	20	20	20	100
Capital gains treatment of royalties on coal	60	60	70	80	100	370
Exclusion of interest on energy facility bonds	30	30	30	30	30	150
New technology credit	1,160	1,430	1,530	1,530	1,500	7,150
Energy investment credit	600	680	420	370	450	2,520
Alcohol fuel credit	8,870	10,940	6,690	3,610	2,030	32,140
Bio-Diesel and small agri-biodiesel producer tax credits	10	0	0	0	0	10
Tax credit and deduction for clean-fuel burning vehicles	260	130	170	230	390	1,180
Exclusion of utility conservation subsidies	130	120	120	120	120	610
Credit for holding clean renewable energy bonds	100	120	140	140	140	640
Deferral of gain from dispositions of transmission property to implement FERC restructuring policy	-400	-460	-490	-500	-470	-2320
Credit for investment in clean coal facilities	480	550	440	360	250	2,080
Temporary 50% expensing for equipment used in the refining of liquid fuels	930	760	630	-300	-790	1,230
Natural gas distribution pipelines treated as 15-year property	120	110	90	80	80	480
Amortize all geological and geophysical expenditures over 2 years	240	240	190	140	90	900
Allowance of deduction for certain energy efficient commercial building property	90	90	130	80	10	400
Credit for construction of new energy efficient homes	20	20	0	0	0	40
Credit for energy efficient improvements to existing homes	1,460	0	0	0	0	1,460
Credit for energy efficient appliances	50	0	0	0	0	50
Credit for residential purchases/installations of solar and fuel cells	180	180	190	190	190	930
Qualified energy conservation bonds	40	80	110	120	120	470
Natural Resources and Environment:						
Expensing of exploration and development costs, nonfuel minerals	90	100	100	100	100	490
Excess of percentage over cost depletion, nonfuel minerals	740	750	770	810	830	3,900
Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	420	520	550	580	610	2,680

	Total from corporations and individuals					
	2011	2012	2013	2014	2015	2011-15
Capital gains treatment of certain timber income	60	60	70	80	100	370
Expensing of multiperiod timber growing costs	290	290	320	310	310	1,520
Tax incentives for preservation of historic structures	470	490	520	540	570	2,590
Exclusion of gain or loss on sale or exchange of certain brownfield sites	60	40	30	10	0	140
Industrial CO2 capture and sequestration tax credit	0	0	0	60	130	190
Deduction for endangered species recovery expenditures	30	30	30	50	50	190
Agriculture:						
Expensing of certain capital outlays	70	80	90	90	90	420
Expensing of certain multiperiod production costs	110	110	120	120	120	580
Treatment of loans forgiven for solvent farmers	20	20	20	20	20	100
Capital gains treatment of certain income	590	550	680	830	970	3,620
Income averaging for farmers	90	90	90	90	100	460
Deferral of gain on sale of farm refiners	20	20	20	20	20	100
Commerce and Housing:						
Financial institutions and insurance:						
Exemption of credit union income	710	790	880	960	1,030	4,370
Exclusion of interest on life insurance savings	23,070	24,700	26,420	28,220	29,860	132,270
Special alternative tax on small property and casualty insurance companies	40	50	50	50	60	250
Tax exemption of certain insurance companies owned by tax-exempt organizations	200	210	210	220	220	1,060
Small life insurance company deduction	50	50	50	50	50	250
Exclusion of interest spread of financial institutions	960	1,070	1,160	1,250	1,330	6,170
Housing:						
Exclusion of interest on owner-occupied mortgage subsidy bonds	1,190	1,470	1,540	1,610	1,710	7,520
Exclusion of interest on rental housing bonds	1,010	1,240	1,300	1,370	1,450	6,370
Deductibility of mortgage interest on owner-occupied homes	104,540	116,620	127,840	139,000	149,560	637,560
Deductibility of State and local property tax on owner-occupied homes	23,710	29,730	31,340	32,700	33,690	151,170
Deferral of income from installment sales	810	880	1,020	1,150	1,260	5,120
Capital gains exclusion on home sales	31,300	39,510	43,640	48,200	53,230	215,880
Exclusion of net imputed rental income	37,630	40,810	41,020	48,330	56,100	223,890
Exception from passive loss rules for $25,000 of rental loss	7,330	8,510	9,670	11,120	13,010	49,640
Credit for low-income housing investments	6,170	6,660	7,540	7,910	8,030	36,310
Accelerated depreciation on rental housing (normal tax method)	5,870	7,100	8,380	9,360	9,970	40,680
Discharge of mortgage indebtedness	200	180	120	0	0	500
Credit for homebuyer	1,530	-1980	-1210	-800	-490	-2,950
Commerce:						
Cancellation of indebtedness	-10	-50	-30	0	40	-50
Exceptions from imputed interest rules	50	50	50	50	50	250
Treatment of qualified dividends	26,869	0	0	0	0	26,869

	Total from corporations and individuals					
	2011	2012	2013	2014	2015	2011-15
Capital gains (except agriculture, timber, iron ore, and coal)	44,290	41,090	51,120	62,230	72,180	270,910
Capital gains exclusion of small corporation stock	170	290	300	470	690	1,920
Step-up basis of capital gains at death	44,520	53,270	57,260	61,560	66,180	282,790
Carryover basis of capital gains on gifts	4,790	2,050	2,740	2,940	3,160	15,680
Ordinary income treatment of loss from small business corporation stock sale	60	60	60	60	60	300
Accelerated depreciation of buildings other than rental housing (normal tax method)	-12,860	-13,960	-15,530	-16,360	-17,540	-76,250
Accelerated depreciation of machinery and equipment (normal tax method)	1,170	14,120	30,710	44,310	56,400	146,710
Expensing of certain small investments (normal tax method)	-3,200	-2,820	-710	210	760	-5,760
Graduated corporation income tax rate (normal tax method)	3,120	3,070	3,150	3,420	3,600	16,360
Exclusion of interest on small issue bonds	320	400	420	430	460	2,030
Deduction for US production activities	13,640	14,420	15,290	16,210	17,120	76,680
Special rules for certain film and TV production	-60	-110	-90	-60	-50	-370
Transportation:						
Deferral of tax on shipping companies	20	20	20	20	20	100
Exclusion of reimbursed employee parking expenses	3,100	3,190	3,320	3,460	3,590	16,660
Exclusion for employer-provided transit passes	530	560	600	640	670	3,000
Tax credit for certain expenditures for maintaining railroad tracks	70	30	10	10	0	120
Exclusion of interest on bonds for Financing of Highway Projects and rail-truck transfer facilities	100	90	60	60	60	370
Community and regional development:						
Investment credit for rehabilitation of structures (other than historic)	30	30	30	30	30	150
Exclusion of interest for airport, dock and similar bonds	850	1,040	1,090	1,140	1,210	5,330
Exemption of certain mutuals' and cooperatives' income	110	110	120	120	120	580
Empowerment zones and renewal communities	430	580	680	740	730	3,160
New markets tax credit	800	810	780	740	660	3,790
Expensing of environmental remediation costs	-140	-140	-140	-130	-120	-670
Credit to holders of Gulf Tax Credit Bonds	80	70	50	50	50	300
Recovery Zone Bonds	30	40	40	40	40	190
Tribal Economic Development Bonds	390	470	490	520	550	2,420
Education, Training, Employment, and Social Services:						
Education:						
Exclusion of scholarship and fellowship income (normal tax method)	2,250	2,340	2,440	2,540	2,650	12,220
HOPE tax credit	840	4,250	4,460	4,680	4,900	19,130
Lifetime Learning tax credit	3,360	4,780	5,010	5,250	5,510	23,910
American Opportunity Tax Credit	11,380	0	0	0	0	11,380
Education Individual Retirement Accounts	70	80	80	90	100	420
Deductibility of student-loan interest	1,130	590	610	640	660	3,630
State prepaid tuition plans	1,580	1,750	1,880	1,950	2,050	9,190
Exclusion of interest on student loan bonds	550	670	710	740	780	3,450

	Total from corporations and individuals					
	2011	2012	2013	2014	2015	2011-15
Exclusion of interest on bonds for private nonprofit educational facilities	2,220	2,720	2,850	3,000	3,170	13,960
Credit for holders of zone academy bonds	260	290	280	250	230	1,310
Exclusion of interest on savings bonds redeemed to finance educational expenses	20	20	20	20	20	100
Parental personal exemption for students age 19 or over	2,780	3,140	2,950	2,750	2,550	14,170
Deductibility of charitable contributions (education)	4,940	5,370	5,800	6,190	6,610	28,910
Exclusion of employer provided educational assistance	30	0	0	0	0	30
Discharge of student loan indebtedness	20	20	20	20	20	100
Qualified school construction bonds	310	630	940	1,060	1,060	4,000
Training, employment, and social services:						
Work opportunity tax credit	830	540	260	130	60	1,820
Welfare-to-work tax credit	10	10	0	0	0	20
Employer-provided child care exclusion	1,370	1,410	1,480	1,550	1,630	7,440
Employer-provided child care credit	10	0	0	0	0	10
Assistance for adopted foster children	490	520	550	580	610	2,750
Adoption credit and exclusion	460	90	90	90	90	820
Exclusion of employee meals and lodging (other than military)	1,110	1,170	1,230	1,300	1,370	6,180
Child credit	18,550	10,870	10,610	10,320	9,990	60,340
Credit for child and dependent care expenses	2,200	1,890	1,830	1,730	1,650	9,300
Credit for disabled access expenditures	20	30	30	30	30	140
Deductibility of charitable contributions, other than education and health	43,850	47,730	51,570	55,140	58,850	257,140
Exclusion of certain foster care payments	400	390	390	390	370	1,940
Exclusion of parsonage allowances	660	700	740	790	840	3,730
Exclusion for benefits provided to volunteer EMS and firefighters	60	0	0	0	0	60
Making work pay tax credit	14,160	0	0	0	0	14,160
Health:						
Exclusion of employer contributions for medical insurance premiums and medical care	176,964	191,540	208,650	228,040	248,600	1,053,794
Self-employed medical insurance premiums	5,740	6,150	6,580	7,120	7,780	33,370
Medical Savings Accounts / Health Savings Accounts	2,130	2,240	2,350	2,470	2,590	11,780
Deductibility of medical expenses	10,030	10,980	11,970	13,260	14,910	61,150
Exclusion of interest on hospital construction bonds	3,350	4,110	4,310	4,540	4,790	21,100
Deductibility of charitable contributions (health)	4,950	5,380	5,810	6,230	6,640	29,010
Tax credit for orphan drug research	320	350	380	410	450	1,910
Special Blue Cross/Blue Shield deduction	690	660	590	530	690	3,160
Tax credit for health insurance purchased by certain displaced and retired individuals	10	10	10	10	10	50
Distributions from retirement plans for premiums for health and long-term care insurance	330	360	400	440	490	2,020
Income security:						
Exclusion of railroad retirement system benefits	300	280	260	250	250	1,340
Exclusion of workmen's compensation benefits	5,940	6,070	6,170	6,270	6,370	30,820

	Total from corporations and individuals					
	2011	2012	2013	2014	2015	2011-15
Exclusion of public assistance benefits (normal tax method)	670	710	740	760	790	3,670
Exclusion of special benefits for disabled coal miners	40	40	40	40	40	200
Exclusion of military disability pensions	110	110	110	110	120	560
Net exclusion of pension contributions and earnings:						
Employer plans	44,630	47,870	49,050	51,950	53,980	247,480
401(k) plans	67,061	70,168	72,716	74,712	76,183	360,840
Individual Retirement Accounts	14,080	15,770	16,190	16,400	16,500	78,940
Low and moderate income savers credit	1,170	1,130	1,060	1,000	960	5,320
Keogh plans	15,120	17,190	19,740	21,100	22,610	95,760
Exclusion of other employee benefits:						
Premiums on group term life insurance	2,160	2,280	2,320	2,350	2,390	11,500
Premiums on accident and disability insurance	340	350	360	360	360	1,770
Income of trusts to finance supplementary unemployment benefits	50	50	50	50	60	260
Special ESOP rules	1,800	1,900	2,000	2,100	2,200	10,000
Additional deduction for the blind	40	50	50	50	50	240
Additional deduction for the elderly	2,600	3,100	3,300	3,550	3,690	16,240
Tax credit for the elderly and disabled	10	10	10	10	10	50
Deductibility of casualty losses	640	680	720	750	780	3,570
Earned income tax credit[9]	8,200	8,380	8,540	8,790	9,090	41,000
Social Security:						
Exclusion of social security benefits:						
Social Security benefits for retired workers	20,240	21,380	22,560	24,160	26,810	115,150
Social Security benefits for disabled workers	7,160	7,450	7,750	8,080	8,580	39,020
Social Security benefits for spouses, dependents and survivors	3,140	3,150	3,170	3,200	3,330	15,990
Veterans benefits and services:						
Exclusion of veterans death benefits and disability compensation	4,370	4,630	4,910	5,200	5,510	24,620
Exclusion of veterans pensions	220	250	260	270	270	1,270
Exclusion of GI bill benefits	770	1,010	1,270	1,570	1,910	6,530
Exclusion of interest on veterans housing bonds	30	40	50	60	60	240
General purpose fiscal assistance:						
Exclusion of interest on public purpose State and local bonds	28,660	35,130	36,900	38,780	40,910	180,380
Build America Bonds	-2,120	-2,110	-2,030	-1,960	-1,880	-10,100
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	46,500	58,100	61,890	65,320	68,250	300,060
Interest:						
Deferral of interest on savings bonds	1,220	1,300	1,320	1,330	1,340	6,510
Addendum—Aid to State and local governments:						
Deductibility of:						
Property taxes on owner-occupied homes	23,710	29,730	31,340	32,700	33,690	151,170

9. The figures in the table indicate the effect of the earned income tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: * * * 2011 $51,450; 2012 $43,980; 2013 $43,860; 2014 $44,130; and 2015 $44,380.

	Total from corporations and individuals					
	2011	2012	2013	2014	2015	2011-15
Nonbusiness State and local taxes other than on owner-occupied homes	46,500	58,100	61,890	65,320	68,250	300,060
Exclusion of interest on State and local bonds for:						
Public purposes	28,660	35,130	36,900	38,780	40,910	180,380
Energy facilities	30	30	30	30	30	150
Water, sewage, and hazardous waste disposal facilities	420	520	550	580	610	2,680
Small issues	320	400	420	430	460	2,030
Owner-occupied mortgage subsidies	1,190	1,470	1,540	1,610	1,710	7,520
Rental housing	1,010	1,240	1,300	1,370	1,450	6,370
Airports, docks, and similar facilities	850	1,040	1,090	1,140	1,210	5,330
Student loans	550	670	710	740	780	3,450
Private nonprofit educational facilities	2,220	2,720	2,850	3,000	3,170	13,960
Hospital construction	3,350	4,110	4,310	4,540	4,790	21,100
Veterans' housing	20	20	20	20	20	100
GO Zones and GO Zone mortgage	90	110	120	120	130	610
Credit for holders of zone academy bonds	260	290	280	250	230	1310

Note: Provisions with estimates denoted normal tax method have no revenue loss under the reference tax law method. All estimates have been rounded to the nearest $10 million. Provisions with estimates that rounded to zero in each year are not included in the table.

were enacted in the Jobs and Growth Tax Relief Reconciliation Act of 2003 were not identified as a tax expenditure. In this volume, the estimates reflect the pre-2005 methodology * * * . The preferential rate on qualified dividends is identified as a tax expenditure.

Interpreting Tax Expenditure Estimates

The estimates shown for individual tax expenditures * * * do not necessarily equal the increase in Federal revenues (or the change in the budget balance) that would result from repealing these special provisions, for the following reasons.

First, eliminating a tax expenditure may have incentive effects that alter economic behavior. * * * For example, if capital gains were taxed at ordinary rates, capital gain realizations would be expected to decline, resulting in lower tax receipts. Such behavioral effects are not reflected in the estimates.

Second, tax expenditures are interdependent even without incentive effects. Repeal of a tax expenditure provision can increase or decrease the tax revenues associated with other provisions. For example, even if behavior does not change, repeal of an itemized deduction could increase the revenue costs from other deductions because some taxpayers would be moved into higher tax brackets. Alternatively, repeal of an itemized deduction could lower the revenue cost from other deductions if taxpayers are led to claim the standard deduction instead of itemizing. Similarly, if two provisions were repealed

Table 16-3. INCOME TAX EXPENDITURES RANKED BY TOTAL 2011-2015 PROJECTED REVENUE EFFECT

(In millions of dollars)

Provision	2011	2011-15
Exclusion of employer contributions for medical insurance premiums and medical care	176,964	1,053,794
Deductibility of mortgage interest on owner-occupied homes	104,540	637,560
401(k) plans	67,061	360,840
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	46,500	300,060
Step-up basis of capital gains at death	44,520	282,790
Capital gains (except agriculture, timber, iron ore, and coal)	44,290	270,910
Deductibility of charitable contributions, other than education and health	43,850	257,140
Employer plans	44,630	247,480
Exclusion of net imputed rental income	37,630	223,890
Capital gains exclusion on home sales	31,300	215,880
Exclusion of interest on public purpose State an local bonds	28,660	180,380
Deductibility of State and local property tax on owner-occupied homes	23,710	151,170
Accelerated depreciation of machinery and equipment (normal tax method)	1,170	148,710
Exclusion of interest on life insurance savings	23,070	132,270
Social Security benefits for retired workers	20,240	115,150
Keogh Plans	15,120	95,760
Individual Retirement Accounts	14,080	78,940
Deduction for US production activities	13,640	76,680
Deductibility of medical expenses	10,030	61,150
Child Credit	18,550	60,340
Exclusion of benefits and allowances to armed forces personnel	11,530	60,250
Exception from passive loss rules for $25,000 of rental loss	7,330	49,640
Earned income tax credit	6,200	41,000
Accelerated depreciation on rental housing (normal tax method)	5,870	40,680
Social Security benefits for disabled workers	7,160	39,020
Credit for low-income housing investments	6,170	36,310
Deferral of income from controlled foreign corporations (normal tax method)	32,720	35,840
Self-employed medical insurance premiums	5,740	33,370
Exclusion of income earned abroad by U.S. citizens	5,870	32,420
Alcohol fuel credits	8,870	32,140
Expensing of research and experimentation expenditures (normal tax method)	4,560	31,610
Exclusion of workers' compensation benefits	5,940	30,820
Deductibility of charitable contributions (health)	4,950	29,010
Deductibility of charitable contributions (education)	4,940	28,910
Treatment of qualified dividends	26,869	26,869
Exclusion of veterans death benefits and disability compensation	4,370	24,620
Lifetime Learning tax credit	3,360	23,910
Exclusion of interest on hospital construction bonds	3,350	21,100
HOPE tax credit	840	19,130
Inventory property sales source rules exception	2,830	18,700
Exclusion of reimbursed employee parking expenses	3,100	16,660
Graduated corporation income tax rate (normal tax method)	3,120	16,360
Additional deduction for the elderly	2,600	16,240
Social Security benefits for spouses, dependents and survivors	3,140	15,990
Carryover basis of capital gains on gifts	4,790	15,680

Provision	2011	2011-15
Parental personal exemption for students age 19 or over	2,780	14,170
Making work pay tax credit	14,160	14,160
Exclusion of interest on bonds for private nonprofit educational facilities	2,220	13,960
Credit for increasing research activities	3,850	12,922
Exclusion of scholarship and fellowship income (normal tax method)	2,250	12,220
Medical Savings Accounts / Health Savings Accounts	2,130	11,780
Premiums on group term life insurance	2,160	11,500
Lifetime Learning tax credit	11,380	11,380
Special ESOP rules	1,800	10,000
Credit for child and dependent care expenses	2,200	9,300
State prepaid tuition plans	1,580	9,190
Exclusion of interest on owner-occupied mortgage subsidy bonds	1,190	7,520
Employer provided child care exclusion	1,370	7,440
New technology credit	1,160	7,150
Exclusion of GI bill benefits	770	6,530
Deferral of interest on U.S. savings bonds	1,220	6,510
Exclusion of interest on rental housing bonds	1,010	6,370
Deferred taxes for financial firms on certain income earned overseas	5,770	6,320
Exclusion of employee meals and lodging (other than military)	1,110	6,180
Exclusion of interest spread of financial institutes	960	6,170
Exclusion of certain allowances for Federal employees abroad	1,020	5,630
Exclusion of interest for airport, dock, and similar bonds	850	5,330
Low and moderate income savers credit	1,170	5,320
Deferral of income from installment sales	810	5,120
Excess of percentage over cost depletion, fuels	670	5,090
Exemption of credit union income	710	4,370
Expensing of exploration and development costs, fuels	1,180	4,020
Qualified school construction bonds	310	4,000
Excess of percentage over cost depletion, nonfuel minerals	740	3,900
New markets tax credit	800	3,790
Exclusion of parsonage allowances	660	3,730
exclusion of public assistance benefits (normal tax method)	670	3,670
Deductibility of student-loan interest	1,130	3,630
Capital gains treatment of certain income	590	3,620
Deductibility of casualty losses	640	3,570
Exclusion of interest on student-loan bonds	550	3,450
Empowerment zones, Enterprise communities, and Renewal communities	430	3,160
Special Blue Cross/Blue Shield deduction	690	3,160
Exclusion for employer-provided transit passes	530	3,000
Assistance for adopted foster children	490	2,750
Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	420	2,680
Tax incentives for preservation of historic structures	470	2,590
Energy investment credit	600	2,520
Tribal Economic Development Bonds	390	2,420
Credit for investment in clean coal facilities	480	2,080
Exclusion of interest on small issue bonds	320	2,030
Distribution from retirement plans for premiums for health and long-term care insurance	330	2,020

Provision	2011	2011-15
Exclusion of certain foster care payments	400	1,940
Capital gains exclusion of small corporation stock	170	1,920
Tax credit for orphan drug research	320	1,910
Work opportunity tax credit	830	1,820
Premiums on accident and disability insurance	340	1,770
Expensing of multiperiod timber growing costs	290	1,520
Credit for energy efficiency improvements to existing homes	1,460	1,460
Exclusion of railroad retirement system benefits	300	1,340
Credit for holders of zone academy bonds	260	1,310
Exclusion of veterans pensions	220	1,270
Temporary 50% expensing for equipment used in the refining of liquid fuels	930	1,230
Tax credit and deduction for clean-fuel burning vehicles	260	1,180
Tax exemption of certain insurance companies owned by tax-exempt organizations	200	1,060
30% credit for residential purchases/installations of solar and fuel cells	180	930
Amortize all geological and geophysical expenditures over 2 years	240	900
Adoption credit and exclusion	460	820
Credit for holding clean renewable energy bonds	100	640
Exclusion of utility conservation subsidies	130	610
Expensing of certain multiperiod production costs	110	580
Exemption of certain mutuals' and cooperatives' income	110	580
Exclusion of military disability pensions	110	560
Discharge of mortgage indebtedness	200	500
Expensing of exploration and development costs, nonfuel minerals	90	490
Natural gas distribution pipelines treated as 15-year property	120	480
Qualified energy conservation bonds	40	470
Income averaging for farmers	90	460
Expensing of certain capital outlays	70	420
Education Individual Retirement Accounts	70	420
Allowance of deduction for certain energy efficient commercial building property	90	400
Capital gains treatment of royalties on coal	60	370
Capital gains treatment of certain timber income	60	370
Exclusion of interest on bonds for Financing of Highway Projects and rail-truck transfer facilities	100	370
Ordinary income treatment of loss from small business corporation stock sale	60	300
Credit to holders of Gulf Tax Credit Bonds	80	300
Income of trusts to finance supplementary unemployment benefits	50	260
Special alternative tax on small property and casualty insurance companies	40	250
Small life insurance company deduction	50	250
Exceptions from imputed interest rules	50	250
Additional deduction for the blind	40	240
Exclusion of interest on veterans housing bonds	30	240
Exclusion of special benefits for disabled coal miners	40	200
Industrial CO2 capture and sequestration tax credit	0	190
Deduction for endangered species recovery expenditures	30	190
Recovery Zone Bonds	30	190
Exclusion of interest on energy facility bonds	30	150
Investment credit for rehabilitation of structures (other than historic)	30	150
Exclusion of gain or loss on sale or exchange of certain brownfield sites	60	140

Provision	2011	2011-15
Credit for disabled access expenditures	20	140
Tax credit for certain expenditures for maintaining railroad tracks	70	120
Exception from passive loss limitation for working interests in oil and gas properties	20	100
Treatment of loans forgiven for solvent farmers	20	100
Deferral of gain on sale of farm refiners	20	100
Deferral of tax on shipping companies	20	100
Exclusion of interest on savings bonds redeemed to finance educational expenses	20	100
Discharge of student loan indebtedness	20	100
Exclusion for benefits provided to volunteer EMS and firefighters	60	60
Credit for energy efficient appliances	50	50
Tax credit for health insurance purchased by certain displaced and retired individuals	10	50
Tax credit for the elderly and disabled	10	50
Credit for construction of new energy efficient homes	20	40
Alternative fuel production credit	20	30
Exclusion of employer-provided educational assistance	30	30
Welfare-to-work tax credit	10	20
Bio-Diesel and small agr-biodiesel producer tax credits	10	10
Employer-provided child care credit	10	10
Cancellation of indebtedness	-10	-50
Special rules for certain firm and TV production	-60	-370
Expensing of environmental remediation costs	-140	-670
Deferral of gain from dispositions of transmission property to implement FERC restructuring policy	-400	-2,320
Credit for homebuyers	1,530	-2,950
Expensing of certain small investments (normal tax method)	-3,200	-5,760
Build America Bonds	-2,120	-10,100
Accelerated depreciation of buildings other than rental housing (normal tax method)	-12,860	-76,250

simultaneously, the increase in tax liability could be greater or less than the sum of the two separate tax expenditures, because each is estimated assuming that the other remains in force. * * *

Present-Value Estimates

The annual value of tax expenditures for tax deferrals is reported on a cash basis in all tables except Table 16–4. Cash-based estimates reflect the difference between taxes deferred in the current year and incoming revenues that are received due to deferrals of taxes from prior years. Although such estimates are useful as a measure of cash flows into the Government, they do not accurately reflect the true economic cost of these provisions. For example, for a provision where activity levels have changed, so that incoming tax receipts from past deferrals are greater than deferred receipts from new activity, the cash-basis tax expenditure estimate can be negative, despite the fact that in present-value terms current deferrals have a real cost to the Government. Alternatively, in the case of a newly enacted deferral provision, a cash-based estimate can overstate the real effect on receipts to the Government because the newly deferred taxes will ultimately be received.

Discounted present-value estimates of revenue effects are presented in

Table 16–4 for certain provisions that involve tax deferrals or other long-term revenue effects. These estimates complement the cash-based tax expenditure estimates presented in the other tables.

The present-value estimates represent the revenue effects, net of future tax payments that follow from activities undertaken during calendar year 2009 which cause the deferrals or other long-term revenue effects. For instance, a pension contribution in 2009 would cause a deferral of tax payments on wages in 2009 and on pension fund earnings on this contribution (e.g., interest) in later years. In some future year, however, the 2009 pension contribution and accrued earnings will be paid out and taxes will be due; these receipts are included in the present-value estimate. * * *

Tax Expenditure Baselines

A tax expenditure is an exception to baseline provisions of the tax structure that usually results in a reduction in the amount of tax owed. The 1974 Congressional Budget Act, which mandated the tax expenditure budget, did not specify the baseline provisions of the tax law. As noted previously, deciding whether provisions are exceptions, therefore, is a matter of judgment. As in prior years, most of this year's tax expenditure estimates are presented using two baselines: the normal tax baseline and the reference tax law baseline. Tax expenditures may take the form of credits, deductions, special exceptions and allowances, and reduce tax liability below the level implied by the baseline tax system.

The normal tax baseline is patterned on a practical variant of a comprehensive income tax, which defines income as the sum of consumption and the change in net wealth in a given period of time. The normal tax baseline allows personal exemptions, a standard deduction, and deduction of expenses incurred in earning income. It is not limited to a particular structure of tax rates, or by a specific definition of the taxpaying unit.

The reference tax law baseline is also patterned on a comprehensive income tax, but it is closer to existing law. Reference law tax expenditures are limited to special exceptions from a generally provided tax rule that serve programmatic functions in a way that is analogous to spending programs. Provisions under the reference law baseline are generally tax expenditures under the normal tax baseline, but the reverse is not always true.

Both the normal and reference tax baselines allow several major departures from a pure comprehensive income tax. For example, under the normal and reference tax baselines:

- Income is taxable only when it is realized in exchange. Thus, the deferral of tax on unrealized capital gains is not regarded as a tax expenditure. Accrued income would be taxed under a comprehensive income tax.
- There is a separate corporate income tax. Under a comprehensive income tax, corporate income would be taxed only once—at the shareholder level, whether or not distributed in the form of dividends.
- Noncorporate tax rates vary by level of income.
- Individual tax rates, including brackets, standard deduction, and

personal exemptions, are allowed to vary with marital status.

- Values of assets and debt are not generally adjusted for inflation. A comprehensive income tax would adjust the cost basis of capital assets and debt for changes in the general price level. Thus, under a comprehensive income tax baseline, the failure to take account of inflation in measuring depreciation, capital gains, and interest income would be regarded as a negative tax expenditure (i.e., a tax penalty), and failure to take account of inflation in measuring interest costs would be regarded as a positive tax expenditure (i.e., a tax subsidy).

Although the reference law and normal tax baselines are generally similar, areas of difference include:

Tax rates. The separate schedules applying to the various taxpaying units are included in the reference law baseline. Thus, corporate tax rates below the maximum statutory rate do not give rise to a tax expenditure. The normal tax baseline is similar, except that, by convention, it specifies the current maximum rate as the baseline for the corporate income tax. The lower tax rates applied to the first $10 million of corporate income are thus regarded as a tax expenditure under the normal tax. By convention, the Alternative Minimum Tax is treated as part of the baseline rate structure under both the reference and normal tax methods.

Income subject to the tax. Income subject to tax is defined as gross income less the costs of earning that income. Under the reference tax rules, gross income does not include gifts defined as receipts of money or property that are not consideration in an exchange nor does gross income include most transfer payments from the Government.[2] The normal tax baseline also excludes gifts between individuals from gross income. Under the normal tax baseline, however, all cash transfer payments from the Government to private individuals are counted in gross income, and exemptions of such transfers from tax are identified as tax expenditures. The costs of earning income are generally deductible in determining taxable income under both the reference and normal tax baselines.

Capital recovery. Under the reference tax law baseline no tax expenditures arise from accelerated depreciation. Under the normal tax baseline, the depreciation allowance for property is computed using estimates of economic depreciation.

Treatment of foreign income. Both the normal and reference tax baselines allow a tax credit for foreign income taxes paid (up to the amount of U.S. income taxes that would otherwise be due), which prevents double taxation of income earned abroad.

2. Gross income does, however, include transfer payments associated with past employment, such as Social Security benefits.

Table 16-4. PRESENT VALUE OF SELECTED TAX EXPENDITURES FOR ACTIVITY IN CALENDAR YEAR 2009
(In millions of dollars)

Provision	Present Value of Revenue Loss
Deferral of income from controlled foreign corporations (normal tax method)	20,060
Deferred taxes for financial forms on income earned overseas	3,540
Expensing of research and experimentation expenditures (normal tax method)	2,750
Credit for holding clean renewable energy bonds	350
Expensing of exploration and development costs—fuels	275
Expensing of exploration and development costs-nonfuels	130
Expensing of multiperiod timber growing costs	90
Expensing of certain multiperiod production costs—agriculture	180
Expensing of certain capital outlays—agriculture	120
Deferral of income on life insurance and annuity contracts	19,400
Accelerated depreciation on rental housing	6,980
Accelerated depreciation of buildings other than rental	-15,850
Accelerated depreciation of machinery and equipment	3,150
Expensing of certain small investments (normal tax method)	-40
Deferral of tax on shipping companies	20
Credit for holders of zone academy bonds	610
Credit for low-income housing investments	5,420
Deferral for state prepaid tuition plans	7,100
Exclusion of pension contributions—employer plans	74,280
Exclusion of 401(k) contributions	113,000
Exclusion of IRA contributions and earnings	4,000
Exclusion of Roth earnings and distributions	11,200
Exclusion of non-deductible IRA earnings	510
Exclusion of contributions and earnings for Keogh plans	6,270
Exclusion of interest on public-purpose bonds	26,470
Exclusion of interest on non-public purpose bonds	11,460
Deferral of interest on U.S. savings bonds	270

* * *

Appendix: Performance Measures and the Economic Effects of Tax Expenditures

The Government Performance and Results Act of 1993 (GPRA) directs Federal agencies to develop annual and strategic plans for their programs and activities. These plans set out performance objectives to be achieved over a specific time period. Most of these objectives are achieved through direct expenditure programs. Tax expenditures, however, may also contribute to achieving these goals. * * *

Comparison of tax expenditure, spending, and regulatory policies. Tax expenditures by definition work through the tax system and, particularly, the income tax. Thus, they may be relatively advantageous policy approaches when the benefit or incentive is related to income and is intended to be widely available. Because there is an existing public administrative and private compliance structure for the tax system, the incremental administrative and compliance costs for a tax expenditure may be low in many cases. In addition, some tax expenditures actually simplify the operation of the tax system, (for example, the exclusion for up to $500,000 of capital gains on home sales). * * *

[A] variety of tax expenditure tools can be used, e.g., deductions; credits; exemptions; deferrals, floors, ceilings; phase-ins; phase-outs; and these can be dependent on income, expenses, or demographic characteristics (age, number of family members, etc.). This wide range of policy instruments means that tax expenditures can be flexible and can have very different economic effects.

Tax expenditures also have limitations. In many cases they add to the complexity of the tax system, which raises both administrative and compliance costs. For example, personal exemptions, deductions, credits, and phase-outs can complicate filing and decision-making. The income tax system may have little or no contact with persons who have no or very low incomes, and does not require information on certain characteristics of individuals used in some spending programs, such as wealth. These features may reduce the effectiveness of tax expenditures for addressing socioeconomic disparity. Tax expenditures also generally do not enable the same degree of agency discretion as an outlay program. * * *

Outlay programs have advantages where direct Government service provision is particularly warranted such as equipping and providing the armed forces or administering the system of justice. Outlay programs may also be specifically designed to meet the needs of low-income families who would not otherwise be subject to income taxes or need to file a tax return. Outlay programs may also receive more year-to-year oversight and fine tuning through the legislative and executive budget process. In addition, many different types of spending programs including direct Government provision; credit programs; and payments to State and local governments, the private sector, or individuals in the form of grants or contracts provide flexibility for policy design. On the other hand, certain outlay programs, such as direct Government service provision, may rely less directly on economic incentives and private-market provision than tax incentives, which may reduce the relative efficiency of spending programs for some goals. Finally, spending programs, particularly on the discretionary side, may respond less readily to changing activity levels and economic conditions than tax expenditures.

Regulations have more direct and immediate effects than outlay and tax-expenditure programs because regulations apply directly and immediately to the regulated party (i.e., the intended actor) generally in the private sector. Regulations can also be fine-tuned more quickly than tax expenditures because they can often be changed as needed by the Executive Branch without legislation. * * * [R]egulations generally do not directly affect Federal outlays or receipts. Thus, like tax expenditures, they may escape the degree of scrutiny that outlay programs receive. However, major regulations are subjected to a formal regulatory analysis that goes well beyond the analysis required for outlays and tax-expenditures. * * *

Some policy objectives are achieved using multiple approaches. For example, minimum wage legislation, the earned income tax credit, and the food stamp program are regulatory, tax expenditure, and direct outlay programs, respectively, all having the objective of improving the economic

welfare of low-wage workers.

Tax expenditures, like spending and regulatory programs, have a variety of objectives and effects. When measured against a comprehensive income tax, for example, these include: encouraging certain types of activities (e.g., saving for retirement or investing in certain sectors); increasing certain types of after-tax income (e.g., favorable tax treatment of Social Security income); reducing private compliance costs and Government administrative costs (e.g., the exclusion for up to $500,000 of capital gains on home sales); and promoting tax neutrality (e.g., accelerated depreciation in the presence of inflation). Some of these objectives are well suited to quantitative measurement, while others are less well suited. Also, many tax expenditures, including those cited above, may have more than one objective. * * *

ANALYTICAL PERSPECTIVES BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 2009 (APPENDIX)

Office of Management and Budget

Pages 315-18, 320, 322-25 (2008)

Treasury Review of the Tax Expenditure Presentation

This appendix provides a presentation of the Treasury Department's continuing review of the tax expenditure budget. The review focuses on three issues: (1) using comprehensive income as a baseline tax system; (2) using a consumption tax as a baseline tax system; and (3) defining negative tax expenditures (provisions that cause taxpayers to pay too much tax).

* * *

Differences Between Official Tax Expenditures and Those Based on Comprehensive Income

As discussed in the main body of the chapter, tax expenditures are measured relative to normal law or reference law baselines that deviate from a comprehensive concept of income. Consequently, tax expenditures identified in the Budget can differ from those that would be identified under a comprehensive income tax baseline. This appendix compares major tax expenditures listed in the tax expenditure budget with those implied by a comprehensive income baseline.

* * *

Major Tax Expenditures from the Traditional Budget under a Comprehensive Income Tax Baseline

Comprehensive income, also called Haig-Simons income, is the real, inflation-adjusted accretion to one's economic power arising between two points in time, e.g., the beginning and ending of the year. It includes all accretions to wealth, whether or not realized, whether or not related to a market transaction, and whether a return to capital or labor. Inflation-adjusted capital gains (and losses) would be included in

comprehensive income as they accrue. Business investment and casualty losses, including losses caused by depreciation, would be deducted. Implicit returns, such as those accruing to homeowners, also would be included in comprehensive income. A comprehensive income tax baseline would tax all sources of income once and only once. Thus, it would not levy a separate tax on corporate income leading to the double taxation of corporate profits.

Comprehensive income is widely held to be the idealized base for an income tax even though it is not a perfectly defined concept. * * *

Furthermore, comprehensive income does not necessarily represent an ideal tax base * * * . [S]ome elements of comprehensive income would be difficult or impossible to include in a tax system that is administrable.

Classifying individual tax provisions relative to a comprehensive income baseline is difficult in part because of the ambiguity of the baseline. * * * Nonetheless, Appendix Table 1 attempts such a classification for each of thirty illustrative large tax expenditures from the Budget.

Table 1 classifies fifteen of the thirty items as tax expenditures under a comprehensive tax base (those in panel A). Most of these give preferential tax treatment to the return on certain types of savings or investment. They reflect the hybrid nature of the existing tax system * * * .

Panel B displays items that probably are tax expenditures, but that raise additional issues. Current law, for instance, allows deductions for home mortgage interest and for property taxes on owner-occupied housing. The tax expenditure budget includes both of these provisions. A comprehensive tax base would allow both deductions, but it would also include imputed gross rental income. * * *

The next category (panel C) includes items whose treatment is less certain. * * *

Medical expenditures may or may not be an element of income. These expenditures may be viewed as a reduction of net worth (e.g. cost of earning income) rather than as discretionary spending, and so are not really consumption and should be excluded from the tax base. However, expenditures for medical care may be considered as indistinguishable from other consumption items which are not excluded from a comprehensive income base. * * *

The final category (panel D) includes items that would not be tax expenditures under a comprehensive income tax base. A tax based on comprehensive income would allow all losses to be deducted. Hence, the exception from the passive loss rules would not be a tax expenditure.

Major Tax Expenditures under a Comprehensive Income Tax That Are Excluded from the Current Budget

While most of the major tax expenditures in the current budget also would be tax expenditures under a comprehensive income base, there also are tax expenditures relative to a comprehensive income base that are not found on the existing tax expenditure list. These additional tax expenditures include

the imputed return from certain consumer durables (e.g., automobiles), the difference between capital gains (and losses) as they accrue and capital gains as they are realized, private gifts and inheritances received, in-kind benefits from such Government programs as food-stamps, Medicaid, and public housing, the value of payouts from insurance policies, and benefits received from private charities. * * *

Differences Between Official Tax Expenditures and Tax Expenditures Relative to a Consumption Tax Base

* * *

Treatment of Major Tax Expenditure under a Comprehensive Consumption Baseline

* * * [T]he major difference between a comprehensive consumption tax and a comprehensive income tax is in the treatment of saving, or in the taxation of capital income. Consequently, many current tax expenditures related to preferential taxation of capital income would not be tax expenditures under a consumption tax. * * *

Revised Estimates of Selected Tax Expenditures

* * *

Double Tax on Corporate Profits

A comprehensive income tax would tax all sources of income once. Taxes would not vary by type or source of income.

* * *

Appendix Table 3 provides an estimate of the negative tax expenditure caused by the multiple levels of tax on corporate profits. This negative tax expenditure is measured as the shareholder level tax on dividends paid and capital gains realized out of earnings that have been fully taxed at the corporate level. * * *

The negative tax expenditure is large in magnitude; it exceeds $41 billion in the years 2007 through 2013. It is comparable in size (but opposite in sign) to all but the largest official tax expenditures. JGTRRA reduced but did not eliminate the double tax on corporate profits.[h]

h. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) reduced the "double tax" on corporate earnings by taxing most dividends at capital gains rates (which rates were themselves reduced). These tax reductions, along with the rest of the 2003 Act, sunset after 2010. The "double tax" on corporate earnings is the primary issue considered in Chapter Fourteen. (Ed.)

Appendix Table 1. COMPARISON OF CURRENT TAX EXPENDITURES WITH THOSE IMPLIED BY A COMPREHENSIVE INCOME TAX[1]

Description	Revenue Effect 2009
A. Tax Expenditure Under a Comprehensive Income Tax	
Capital gains (except agriculture, timber iron ore, and coal)	55,940
Net exclusion of pension contributions and earnings: 401(k) plans	51,000
Net exclusion of pension contributions and earnings: Employer plans	45,670
Accelerated depreciation of machinery and equipment (normal tax method)	44,120
Capital gains exclusion on home sales	34,710
Exclusion of interest on public purpose State and local bonds	25,900
Exclusion of interest on life insurance savings	23,500
Deferral of income from controlled foreign corporations (normal tax method)	13,780
Net exclusion of pension contributions and earnings: Keogh plans	13,000
Accelerated depreciation on rental housing (normal tax method)	11,760
Net exclusion of pension contributions and earnings: Individual Retirement Accounts	11,700
Exclusion of net imputed rental income on owner-occupied housing	7,550
Exclusion of workers' compensation benefits	5,920
Credit for low-income housing investments	5,780
Expensing of research and experimentation expenditures (normal tax method)	4,990
B. Possibly a Tax Expenditure Under a Comprehensive Income Tax, But With Some Qualifications	
Deductibility of mortgage interest on owner-occupied homes	100,810
Step-up basis of capital gains at death	36,750
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	33,200
Child credit	29,950
Exclusion of Social Security benefits for retired workers	18,640
Deductibility of State and local property tax on owner-occupied homes	16,640
Deduction for U.S. production activities	15,330
Earned income tax credit	5,440
C. Uncertain	
Exclusion of employer contributions for medical insurance premiums and medical care	168,460
Deductibility of charitable contributions, other than education and health	46,980
Deductibility of medical expenses	5,920
Social Security benefits for the disabled	5,810
Deductibility of charitable contributions, health	5,300
Deductibility of charitable contributions, education	5,270
D. Probably Not a Tax Expenditure Under a Comprehensive Income Tax	
Exception from passive loss rules for $25,000 of rental loss	8,840

1. The measurement of certain tax expenditures under a comprehensive income tax baseline may differ from the official budget estimate even when the provision would be a tax expenditure under both baselines. * * *

Appendix Table 3. REVISED TAX EXPENDITURE ESTIMATES[1]

Provision	Revenue Loss 2007	2008	2009	2010	2011	2012	2013
Imputed Rent On Owner-Occupied Housing	3,890	5,440	7,550	10,480	14,540	20,180	28,010
Double Tax on corporate profit[2]	-41,230	-44,340	-46,860	-49,520	-52,340	-55,310	-58,460

* * *

JAMES MADISON AND PUBLIC CHOICE AT GUCCI GULCH: A PROCEDURAL DEFENSE OF TAX EXPENDITURES AND TAX INSTITUTIONS

Edward A. Zelinsky*

102 Yale Law Journal 1165, 1165-79, 1181-82, 1184-87, 1190-92 (1993)

Introduction

Few academic doctrines can claim the intellectual and political success of tax expenditure analysis. In roughly a generation's time,[1] Professor Surrey's procedural and substantive critique of tax subsidies has become entrenched in the law school curriculum and in legal scholarship. More impressively, the tax expenditure concept has been enshrined in federal law[4] and become part of the daily discourse of the national budget process.

In earlier articles, I have revisited the substantive tax expenditure indictment of tax subsidies to suggest that the Surrey school's invariable preference for direct government outlays is misplaced. While the classification of particular features of the Internal Revenue Code as either normative or subsidizing is critical to tax expenditure analysis, that classification cannot always be made with confidence.[6] Moreover, the substantive case against tax

1. Calculations described in the appendix text.

2. This is a negative tax expenditure, a tax provision that overtaxes income relative to the treatment specified by the baseline tax system.

*. At time of original publication, Visiting Professor of Law, Yale Law School; Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University.

1. Professor Surrey developed the fundamental premises of tax expenditure analysis—the classification of tax provisions as normative or subsidizing and the equivalence of the latter to direct spending—during the later years of the Johnson Administration when serving as the Assistant Secretary of the Treasury for Tax Policy.

4. *See* 2 U.S.C. § 640(c)(3) (1988) (adopted as part of Congressional Budget and Impoundment Control Act of 1974, requiring promulgation of annual tax expenditure budget).

6. In particular, I have argued that the Code's present treatment of qualified plans is consistent with the terms of a normative income tax and is therefore undeserving of characterization as a tax expenditure. *See* Edward A. Zelinsky, *The Tax Treatment of Qualified Plans: A Classic Defense of the Status Quo*, 66 N.C. L. REV. 315 (1988). I have also criticized the reflexive classification as a tax subsidy of the deduction for certain state and local taxes. *See* Edward A. Zelinsky, *The Deductibility of State and Local Taxes: Income Measurement, Tax Expenditures and Partial, Functional Deductibility*, 6 AM. J. TAX POLICY 9 (1987). Professor Kahn has similarly suggested that accelerated

subsidies depends upon a comparison of such subsidies with an idealized vision of direct spending. In theory, tax expenditures can be designed as efficiently and progressively as programs using direct governmental outlays. On the other hand, if we compare the messy realities of tax preferences with the equally unattractive realities of direct expenditure programs, tax preferences emerge better than most of the Surrey school would acknowledge. Indeed, in particular cases, a tax subsidy may be more efficient than an equivalent direct spending program because such a subsidy uses the pre-existing tax system to communicate federal policy at relatively low marginal cost. Thus, as a matter of substantive policy, a certain agnosticism is in order: in some instances, direct government outlays will be preferable to comparable tax expenditures; in other cases, a subsidy through the Internal Revenue Code will be the preferred means of implementing federal policy.

In this Article, I revisit the procedural aspects of the tax expenditure critique to argue against that critique insofar as it is premised on the asserted expertise of direct expenditure institutions. The core of my argument is that the institutions formulating and administering tax policy are more competitive and visible than their direct outlay counterparts because tax institutions are subject to more numerous and diverse constituencies than the specialized, limited-clientele organizations that design and implement direct government spending. Tax institutions, because of their greater visibility and more competitive nature, are less susceptible to interest group capture and possess greater legitimacy under pluralist criteria than their direct expenditure equivalents. This perspective leads to a form of agnosticism as well: the congressional committees that design and the administrative agencies that implement tax subsidies may, in particular cases, be preferable to their direct expenditure counterparts.

To develop my argument, I will initially review the procedural case against tax preferences and will then contrast the expertise-based premise of this perspective with the Madisonian/public choice/pluralist tradition in American political thought, a tradition that focuses, not upon the asserted proficiencies of policymakers, but upon the interplay of competing interest groups in the political process. * * * I will then elaborate my argument about the differences between the administrative agencies and congressional

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depreciation may be consistent with the provisions of a normative income tax. *See* Douglas A. Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1 (1979). Professor Stein, on the other hand, has vigorously contested my views, defending the classification as a tax subsidy of the Code's qualified plan provisions. *See* Norman P. Stein, *Qualified Plans and Tax Expenditures: A Reply to Professor Zelinsky*, 9 AM. J. TAX POL'Y 225 (1991); Edward A. Zelinsky, *Qualified Plans and Identifying Tax Expenditures: A Rejoinder to Professor Stein*, 9 AM. J. TAX POL'Y 257 (1991); *see also* Douglas A. Kahn & Jeffery S. Lehman, *Tax Expenditure Budgets: A Critical View*, 54 TAX NOTES 1661, 1664 (1992) ("[V]ery few items fit neatly into" categories of normative and subsidizing); Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155, 1156 (1988) (introducing "substitutable tax provisions" concept).

committees that formulate and implement direct expenditure programs and the equivalent tax organizations.

Let me emphasize at the outset, what I am not saying: I am not suggesting that the institutions that design and implement the tax law are immune from capture by interest groups or perfectly implement the pluralist model of democracy. I am not declaring that, in all cases, a tax subsidy is better designed and administered than its direct expenditure counterpart or that the interplay of interest groups mechanically dictates legislative and administrative outcomes: ideology, accident, history, inertia, partisanship, public opinion, cultural norms, bureaucratic aggrandizement, the idiosyncrasies of legislators and the legislative process, and the personalities and proclivities of individual decisionmakers, as well as their concern for the public interest, all affect the outcomes of political and administrative processes. The procedures by which taxes are designed and administered are not ideal or pretty or inhabited exclusively by the pure of heart.

I am suggesting that, in the long term, institutional differences of the sort I explore below do systematically affect legislative and bureaucratic outcomes for better and for worse. A defense of the tax system along these lines constitutes an important counterweight to the widespread, contemporary disillusionment with that system.

The Procedural Case Against Tax Expenditures: the Expertise of Direct Expenditure Institutions

In its original incarnation, the procedural critique of tax subsidies embodied two basic concerns: that such subsidies, undisclosed in the federal budget, were not subject to the same scrutiny as direct monetary expenditures, and that such subsidies, designed and implemented by congressional tax-writers and the Department of the Treasury, were not formed or administered using the specialized subject matter expertise of the other committees of Congress and the nontax executive departments.

The first part of this critique gave rise to the proposal for the tax expenditure budget, the annual identification, as part of the federal government's regular budgetary process, of the subsidies contained in the Internal Revenue Code and of their projected costs. Today, the preparation of such a budget is required by statute. Not surprisingly, much political and academic attention has been devoted to determining the items properly included in the yearly tax expenditure budget and the revenues foregone as a result of such items.

While the tax expenditure school had quick (and, I think, useful) success in persuading Congress of the need for an annual tax expenditure budget, it has had less impact *vis-à-vis* the second element of its procedural critique, i.e., the failure, in the design and implementation of tax preferences, to utilize the subject matter expertise of the nontax congressional committees and executive departments. Professor Yorio expressed the concern in these terms:

> The process by which tax subsidies are enacted and administered also increases the risk that they would fail a cost-benefit test. To

begin with, a tax subsidy enters the Code after review primarily by the House Ways and Means Committee and the Senate Finance Committee. Charged principally with matters of tax and finance, both committees are usually less informed about the specifics of the problems justifying government intervention than those Congressional committees that grapple regularly with the problems. Moreover, the duty of administering tax subsidies is left to the Internal Revenue Service (IRS), which generally has no particular expertise with respect to the problem that the preference was enacted to remedy. Although it may be theoretically possible for the relevant tax committees and the IRS to obtain and digest the information required to make a rational cost-benefit decision about a specific tax expenditure, the process of education and learning is likely to be haphazard and incomplete. As a practical matter, it is virtually impossible for two congressional committees and one administrative agency to master the plethora and diversity of proposals for using the Code to accomplish societal goals.[15]

From one vantage point, this critique is easily remedied by making the enactment and implementation of tax preferences a joint undertaking of the relevant tax and nontax institutions. Subsidies implemented through the Code can, before or after passage by the Ways and Means and Finance Committees, be submitted to additional expert review by the proper subject matter committees of Congress. Congress can—and, on occasion, does—provide for the joint administration of particular tax subsidies by the IRS and the appropriate nontax administrative agency.[17] * * *

On the most fundamental level, the expertise critique of tax expenditures invokes the important notion in American political culture that disinterested, "trained, nonpartisan experts [can] best manage the subtle and difficult social questions of the modern world."[20] From this vantage point, Professor Surrey's procedural case for the subject matter proficiency of nontax institutions is an appeal to the managerial and technocratic values underpinning such expert-oriented institutions as civil service systems, independent regulatory agencies, and municipal governments run by city managers. Professor Surrey's perspective is thus firmly rooted in the tradition of Progressive, New Deal, and good government reformers who placed great confidence in the processes and outcomes of professional decisionmaking—a tradition which, in Professor Banfield's apt, but wary, description, seeks "to replace politicians with

15. Edward Yorio, *Equity, Efficiency, and the Tax Reform Act of 1986*, 55 FORDHAM L. REV. 395, 425 (1987).

17. For example, under the low-income housing credit established in Section 42, important administrative functions are assigned to the U.S. Department of Housing and Urban Development and the U.S. Department of Agriculture.

20. LEWIS L. GOULD, REFORM AND REGULATION, AMERICAN POLITICS FROM ROOSEVELT TO WILSON 210 (2d ed. 1986).

experts."[21]

Interest Group Theory: Madison, Pluralism, Public Choice, and Monitoring Political Agents

James Madison, in contrast, was skeptical of institutional arrangements that presume "[e]nlightened statesmen will . . . always be at the helm" of government.[22] For Madison, self-government is not a matter of entrusting public authority to experts but, rather, of coping with the inevitable "spirit of party and faction in the necessary and ordinary operations of government."[23]

* * *

In much contemporary discussion, Madison's concerns are echoed in the vocabulary of public choice. * * * An important variant of this perspective "conceives regulation as a service supplied to effective political interest groups."[29]

Public choice analysis—emphasizing the rent-seeking nature of interest group activity, the incentives of political entrepreneurs to supply such groups, collective action problems which prevent the effective organization of the public at large, and the capture of legislatures and administrative agencies by organized, concentrated constituencies—reinforces Madison's preference for competitive political processes that pit diverse and conflicting groups against one another. While it is possible in a Madisonian process for interests to respond to their situation collusively rather than competitively, attempting to satisfy their respective needs by combining into broad, mutually useful coalitions, nevertheless, insofar as the legislative or administrative environment approaches Madison's ideal, the presence of more diverse and numerous interest groups discourages such logrolling: more heterogeneous groups will find it more difficult to negotiate mutually acceptable positions for a common front; more numerous groups will find it more costly to bargain with one another and more difficult to detect and prevent defection from and freeloading on the coalition.

* * * [R]elatively closed processes, less visible to some groups or to the general public than to other groups, are more easily captured by the interests that can readily monitor those processes and therefore intelligently punish and reward such processes' decisionmakers. Conversely, more visible institutions, subject to effective oversight by numerous and diverse interests and by the public as a whole, are less prone to capture by any particular clientele since competing interests and the general public are all watching.

Madison's view of organized constituencies, some would assert, is overly pessimistic, ignoring the possibility (and the reality) that "factions" can (and do) play a constructive role in the body politic.

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21. EDWARD C. BANFIELD, HERE THE PEOPLE RULE 170 (2d ed. 1991).
22. *See* THE FEDERALIST NO. 10, at 80 (James Madison) (Clinton Rossiter ed., 1961).
23. *Id.* at 79.
29. Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. MGMT. SCI. 335, 356 (1974).

* * * [F]rom the perspective I advance, it is not necessary that any (or all) of the interest group theories explain exhaustively all political behavior; it is merely necessary to start with their common teaching that political institutions influenced by more numerous and more diverse groups are preferable to governmental organizations influenced by more limited and more homogeneous constituencies.

* * *

It is thus important to reiterate the asymmetry between the invariable preference of the Surrey school for direct monetary expenditures and my more agnostic perspective. I am not advancing a countermyth that the processes that formulate and administer tax subsidies are invariably superior to their direct expenditure counterparts. In particular cases, the benefits flowing from the expertise of a nontax committee or of a direct expenditure department may reasonably be perceived as outweighing the correlative dangers of capture. There are also cases where susceptibility to capture is a desired quality, ensuring an intended responsiveness of governmental arrangements to a favored clientele: a grateful nation might rationally prefer veterans institutions beholden and therefore responsive to those who served in the armed services rather than veterans programs administered with less partiality by the IRS or evaluated with less solicitude by the tax committees. The larger points of this Article are that the trade-off between expertise and capture exists, that the choices this trade-off presents should not be ignored simply by asserting the superior expertise of direct expenditure institutions and that, in some instances, the greater independence and visibility of tax-writers and administrators will be preferable to the alleged subject matter proficiency of their more specialized, capturable counterparts in the direct expenditure system.

The Madisonian Nature of Tax Institutions

For purposes of the Surrey critique, we can view tax and direct expenditure policy as formulated and administered in four stages. Initially, the congressional committees design and authorize programs within their respective jurisdictions. Next, the full houses of Congress act on the committees' product. Third, the President approves or disapproves the decision of the House and Senate. Finally, the appropriate executive department executes the program agreed upon by Congress and the President.

The tax expenditure procedural critique is aimed at the first and fourth stages of this process. At the first stage, the critique asserts that the nontax committees of Congress possess expertise due to their specialization in particular subject matters. This expertise is utilized in the formulation of direct spending programs but is not used in the formulation of tax subsidies since such subsidies are designed by the Ways and Means and Finance panels, generalist bodies with less opportunity and less inclination to acquire subject matter proficiency than the narrowly focused nontax committees of Congress.

A similar analysis applies at the fourth stage of the policy process. Direct outlay programs are administered by specialized executive departments which,

it is argued, develop great understanding of the programs they implement and the problems those programs address. In contrast, the Treasury and the IRS, distracted by the need to run the tax system, do not develop comparable expertise as to the subsidies confided to their administration.

The Madisonian/public choice/pluralist perspective suggests that this critique romanticizes the congressional committees that design, and the executive departments that administer, direct spending programs while ignoring the benefits of the more competitive processes through which taxes are formulated and implemented. The specialized orientation of the nontax committees and departments makes each of these institutions highly susceptible to capture by the limited constituencies affected by its comparatively narrow jurisdiction. In pluralist terms, the outcomes emanating from direct expenditure committees and departments possess less legitimacy than if more numerous and more diverse groups were to participate in the deliberations of these institutions.

Consider, for example, the case of agriculture. Many provisions of the Internal Revenue Code can quite comfortably be classified as subsidies for the farm industry.[45] The tax expenditure procedural critique suggests that, as a matter of process, such subsidies should not be designed in Congress' tax-writing committees because these bodies lack the expertise to formulate farm policy. Instead, the agriculture committees should develop farm programs using direct outlays of government funds.

However, within the farm committees there are generally not significant countervailing pressures from nonagricultural constituencies, while in the Ways and Means and Finance panels agricultural interests are forced to contend with the competing pressures of other groups also seeking largesse from the public fisc. * * *

Similarly, the procedural indictment of tax preferences contends that, in the implementation of agricultural subsidies through the Code, the IRS lacks the expertise of the Department of Agriculture. However, in the administration of farm subsidies, the Secretary of the Treasury possesses greater independence from farm interests than the Secretary of Agriculture. The Secretary of Agriculture relies on farm lobbies to support his policy agenda and his department's budget. He and his subordinates may have worked with agricultural interests before appointment and may return to agriculture after government service. When a Secretary of Agriculture proposes to abolish farm subsidies, he strikes at the very rationale for his agency's existence. * * *

In the vocabulary of the economic theory of regulation, the Department of Agriculture and Congress' farm committees supply industry-specific

45. For example, a number of farm assets are singled out statutorily for particularly rapid cost recovery: certain horses, I.R.C. §§ 168(e)(3)(A) (1992), certain agricultural and horticultural structures, I.R.C. §§ 168(e)(3)(D)(I) (1992), and fruit- and nut-bearing trees and vines, I.R.C. §§ 168(e)(3)(D)(ii) (1992). Similarly, qualifying family farms enjoy estate tax benefits, I.R.C. §§ 2032A (1992).

services—agricultural subsidies—to a limited number of buyers—farm interests. In contrast, the Treasury and Congress' tax-writers supply more fungible services—tax subsidies—in a more competitive environment, distinguished by many more possible purchasers and consequent collective action problems.

* * *

Indeed, contra to the Surrey critique, tax institutions, because of their greater political freedom, are better positioned than direct expenditure organizations to design and implement policies informed by expertise. The theoretical skill of direct spending organizations is of little practical significance when the clienteles of such organizations effectively dominate them and their decisions. In contrast, the counterbalancing pressures on tax writers and tax administrators leave them comparatively freer to make decisions informed by expertise if they are so inclined.

In advancing this analysis, I seek neither to demonize direct expenditure institutions nor to create a countermyth about the organizations that formulate and administer tax subsidies. * * *

On the other hand, my analysis is an antidote to the benign, expertise-oriented argument of the Surrey school for the superiority of direct expenditure institutions, and suggests that tax institutions are better than is popularly thought or academically portrayed. Agricultural interests seem to do well in the tax-writing committees; they probably do better in direct spending contexts. Farm interests can view the Secretary of Agriculture as their natural ally; the same cannot be said of the Commissioner of Internal Revenue.[48]

* * *

Doernberg and McChesney take direct aim at the "political fairy tale"[53] of Gucci Gulch, the hallways outside the tax-writing committees densely packed with high paid, well-dressed lobbyists. The conventional story is that the denizens of Gucci Gulch lost in 1986, the general welfare prevailing over special interests in the rewriting of the tax code. In the spirit of public choice theory, Professors Doernberg and McChesney tell us the truth is otherwise: "tax politics as usual, with considerable sums of money changing hands"[55]—tax benefits supplied and purchased.

* * *

[I]n the Doernberg-McChesney analysis, * * * a key piece of evidence is the vast quantum of campaign contributions received from diverse sources by the members of the Finance and Ways and Means panels. Yet, the aggregate size of those donations and the variety of sources suggest that Congress' tax-

46. While I have illustrated my case with the example of agriculture, I could have used the transportation industry, the natural resources lobbies, the real estate business, veterans groups or any of the interests that seek and obtain largesse from the federal fisc.

53. Richard L. Doernberg & Fred S. McChesney, *Doing Good or Doing Well?: Congress and The Tax Reform Act of 1986*, 62 N.Y.U. L. REV. 891 (1987), at 893.

55. *Id.*

writers are not dependent upon any particular set of contributors. For those concerned about interest group capture, such a state of affairs is preferable to the alternative: legislators heavily indebted for campaign funds to limited constituencies. The economic theory of regulation suggests that the senators and representatives who serve on nontax committees will find themselves in this unfortunate situation, highly reliant for campaign funds upon the relatively homogeneous interest groups serviced by the committees on which such legislators sit.

* * *

Objections, Qualifications and Refinements

I now want to anticipate some objections to my analysis and, where appropriate, qualify and refine my argument. First, it can be argued that, if the generalists who write and administer the tax laws are not knowledgeable about particular substantive areas of government, their lack of expertise engenders a form of capture stemming from their consequent dependence on the information provided by interest groups. Bureaucrats in direct expenditure agencies and members of Congress on nontax committees can, the reasoning goes, independently evaluate the data and proposals advanced by constituencies within their respective jurisdictions because such legislators and bureaucrats possess independent, countervailing expertise; tax personnel, in contrast, are more dependent upon importuning constituencies because tax personnel cannot assess the validity of what they are told. When, for example, the farm lobby furnishes data and advice to the Secretary of Agriculture or to members of Congress' agriculture committees, those individuals can evaluate that material for themselves or can turn to professional staff which can evaluate it for them. On the other hand, the argument runs, tax writers and administrators, generalists lacking specialized expertise in agriculture, are effectively captured by the farm lobby on whose information they depend.

By way of rejoinder, I should first make explicit my skepticism towards the claim of expertise for direct expenditure institutions[.] * * *

Finally, even if direct expenditure institutions possess superior expertise in the abstract, such institutions, because of their greater proclivity towards political capture, are less likely than tax organizations to make decisions actually informed by such expertise. Paradoxically, tax decisionmakers, even if theoretically less knowledgeable in particular substantive areas, are better able to make decisions informed by the expertise they do possess because their more competitive, visible environment frees them to use what expertise they have.

These observations, in turn, suggest further qualification of my thesis: as individuals and institutions in the tax process specialize to acquire proficiency in particular areas of substantive policy, the tension between capture and expertise reemerges. A Treasury lawyer who specializes in the tax problems of agriculture acquires industry-specific skills and knowledge likely to affect his views and future employment; a senator with a narrowly-focused concern about the tax problems of agriculture will develop a relationship with the farm

lobby similar to that of a member of the Senate's agriculture panel. If too much substantive policy is channeled through the tax committees and the Treasury, these institutions will be forced to organize themselves internally by subject matter and thus start to resemble their more capturable direct expenditure counterparts. * * * [T]he tax system does not have infinite capacity in the generalist, multi-constituency form in which it exists today; if overutilized, the tax system will be forced to specialize in a fashion which replicates the expertise and capturability characteristics of direct expenditure institutions.

Another possible rejoinder to my analysis would suggest that the competitive nature of the second and third stages of the process for adopting direct government outlays compensates for capture in the first and fourth stages, thereby redeeming the process as a whole from the effects of special interests. The Surrey school could concede that, while the specialized committees of Congress and the nontax departments of the executive branch are highly vulnerable to capture by their respective constituencies, the problem is corrected in the deliberations of the full houses of Congress and in the President's participation in the process. * * *

While there is an element of truth to this line of thought, there is much overstatement in it as well. Left to their own devices, the Department of Agriculture and Congress' agriculture committees would probably devote most of the federal budget to farm subsidies. The full Congress and the President obviously will not let this happen. However, it overstates the corrective influence of the President and Congress as a whole to conclude that they can completely eradicate the consequences of capture in the direct expenditure committees and executive departments. The consensus among scholars studying Congress is that a particular clientele's domination of a committee leads to a final outcome more favorable to that clientele. It is similarly a commonplace among students of American government that an interest group's control of an administrative agency affects the final outcome of the political process in ways favorable to that group.

In terms of the stylized, four stage process, the decisions of legislative committees set agendas and furnish resources for the debates of the full bodies in the second stage, thereby affecting the results of those second stage deliberations. If we view the floors of both houses as arenas dedicated to logrolling, the interest that loses in committee has no log to roll. Conversely, the interest doing well in committee has more logs to roll and, hence, is likely to emerge at the end with a larger portion of the overall largesse being dispensed. By the same token, the President's options are heavily circumscribed by the actions of the federal bureaucracy, actions which frequently constitute services supplied to clientele interests.

* * *

Implications

What, then, are the implications of my analysis? First, and perhaps most important, are its rhetorical ramifications. Embedded in the tax expenditure

literature is an invariable preference, procedural as well as substantive, for direct government outlays. Similarly embedded in popular and academic discourse is a pronounced disillusion with the federal tax system. My analysis suggests a more balanced view of the processes for enacting and administering tax subsidies.

* * *

The organizations that design and implement federal taxes are not ideal or populated by the pure of heart. However, Madison, like his near contemporary Adam Smith, reminds us that perfection is not the criterion against which human institutions ought to be measured and that the utility of such institutions does not depend upon the motives or moral worthiness of those who populate them.

My argument further suggests that tax subsidies ought to be preferred to direct expenditures when there is a need for detached administration and oversight by decisionmakers less susceptible to capture. Because of his competing constituencies and functions, the Secretary of the Treasury is more likely to implement an agricultural program independently of farm lobbyists than the Secretary of Agriculture; the Treasury is also more apt than the Department of Agriculture to disapprove a farm subsidy it administers and propose the subsidy's abolition. An important instance of such detached evaluation is the Treasury's 1984 tax reform study which recommended abolishing a variety of federal tax subsidies for, inter alia, transportation, military and mineral interests.[78] It is hard to conceive of the direct expenditure departments proposing such sweeping repeal of the programs they administer. Similarly, the Ways and Means and Finance panels, because of their greater visibility and offsetting clientele pressures, are better positioned than the direct expenditure committees to oversee subsidy programs objectively.

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Notes and Questions

5. The Office of Management and Budget (OMB) presents a compilation of tax expenditures, valuing each separately, but expressly notes that it cannot provide a total of all the listed tax expenditures. Why does the whole not equal the sum of the parts?

6. In most cases, tax expenditures are designed to bring about changes in the behavior of taxpayers. Thus, to the degree the tax expenditure is successful, we might expect less of the subsidized activity if the subsidy were removed. Nonetheless, the OMB does not reflect such "behavioral effects" in its estimates. Why not?

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78. U.S. DEP'T OF THE TREASURY, 2 TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 47, 223, 324 (1984) (proposing abolition of military-related exclusions from gross income, repeal of variety of tax preferences relative to energy and natural resources, and abolition of tax benefits for merchant marine capital construction fund).